DOCUMENT RESUME

ED 386 340 RC 020 078

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TITLE 1994 Michigan School Finance And Property Tax Reform.
PUB DATE Jan 95
NOTE 10p.; In: Increasing Understanding of Public Problems and Policies, 1994. National Public Policy Education Conference; see RC 020 070.
PUB TYPE Information Analyses (070) -- Speeches/Conference Papers (150)

EDRS PRICE MF01/PC01 Plus Postage.
DESCRIPTORS Educational Change; Educational Equity (Finance); *Educational Finance; Elementary Secondary Education; Expenditure per Student; *Finance Reform; Property Taxes; Public Policy; *School Funds; School Taxes; *State Legislation; *Tax Allocation
IDENTIFIERS Funding Formulas; *Michigan; Reform Efforts

ABSTRACT

The funding and operation of Michigan's K-12 public school system was substantially changed in March 1994, with voter approval of a constitutional amendment and legislative adoption of 24 implementing state statutes. The comprehensive school funding proposal substantially reduced local property taxes; increased, and in some cases decreased, the tax rate of selected state taxes; established new state taxes; and addressed school quality improvement concerns. The reform also provided for the creation of charter schools. The reform measures increased the state's contribution for school funding, reduced the local share (property taxes), and guaranteed a minimum per pupil funding for each of Michigan's 557 public school districts. The success or failure of the enacted reform measures has yet to be determined. Michigan is currently experiencing above average economic growth; thus, state revenue collections have exceeded expectations, creating a small surplus for the school funding program. A revenue shortfall is forecast for the 1996-97 school year, so it is likely that guaranteed funding commitments for K-12 education will result in reductions in other state budget areas. While the new school funding distribution formula closes the funding gap between the highest- and lowest-spending school districts from $7,600 per pupil to $6,200, the funding gap will continue to exist. (TD)

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1994 MICHIGAN SCHOOL FINANCE AND PROPERTY TAX REFORM

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1994 MICHIGAN SCHOOL FINANCE AND PROPERTY TAX REFORM

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The funding and operation of Michigan's K-12 public school education system was substantially changed in March, 1994, with voter approval of a constitutional amendment and legislative adoption of twenty-four implementing state statutes. The comprehensive school funding proposal substantially reduced local property taxes; increased, and in some cases decreased, the tax rate of selected state taxes; established new state taxes; and addressed school quality improvement concerns. The reform also provided for the creation of charter schools. The reform measures increased the state's contribution for school funding, reduced the local share (property taxes), and guaranteed per pupil funding for each of Michigan's 557 public school districts.

Impetus for School Finance Reform

The impetus for the non-marginal change in the method of financing Michigan's K-12 public education system evolved over three decades. Since 1964, fourteen proposed constitutional amendments to reform school finance or property taxation, or both, were placed before Michigan voters (Harvey, Moore and VerBurg). Only one amendment to limit the rate of property tax increase and state tax collections was approved. Prior to the adoption of the school reform package, Michigan schools were financed through a complex funding formula. The formula compared a local district's property tax base wealth and taxing effort against state guaranteed per pupil funding. If a local district's ability to generate per pupil funds exceeded the state guarantee, the district was not eligible for state membership aid and was considered "out-of-formula." The districts that were classified as out-of-formula still received categorical aid funding for special education, transportation, vocational education and other targeted activities. Having property taxes increasing at the local level at a rate faster than the state membership aid guarantee resulted in 39 percent of the state's school district being out-of-formula in 1993.

The disparity in per pupil funding fueled the policy debate on school funding. The 1993-1994 spending per pupil ranged from $2,800 to $10,400, a situation the legislature and schools perceived as no longer acceptable. For the past several years, concern had been ex-

RC 020078

pressed for the quality of the K-12 educational system. Political debate, both within and outside the legislature, centered on the introduction of competition in the production and provision of education through promoting "school of choice" and "charter school" concepts. The school funding debate was further heightened with the early closing of the Kalkaska School District in the spring of 1993 because of lack of funds when district voters rejected two separate property tax millage propositions.

The July Bombshell

The funding change was initiated in July, 1993, when the Michigan legislature exempted all property in the state from millage levied for school operating purposes without adopting an alternative school funding plan. The decision to abolish property taxes for schools was hailed as a bold stroke by some while others likened the political decision to "bungee jumping without knowing the length of the cord" (*The Wall Street Journal*). Intense policy debate ensued between July and December, 1993, about the appropriate mix of taxes and state revenues to be used in replacing the $6.1 billion in property taxes previously allocated to public schools.

Legislative debate focused on the elements to include in the reform package to improve the quality of education; reduce the funding gap between school districts; and determine the guaranteed per pupil funding, which taxes to raise or reduce, and methods for distributing funds to local districts. The legislature was subjected to intensive lobbying by various interest groups ranging from the Michigan Education Association to the state Chamber of Commerce. The decision to offer two funding proposals grew out of a political compromise and insured that schools would have a funding plan in place when school doors opened in September, 1994. Michigan voters approved the constitutional amendment by a margin of 69 to 31 percent.

Basic Provisions of the Reform Package

The constitutional amendment increased the general sales tax rate from 4 percent to 6 percent, established a cap on individual property assessments at 5 percent or the rate of inflation (whichever is less); required a three-fourths vote of the legislature on changes in laws related to the amount of property taxes that can be used by schools; earmarked 6 percent of the increased tobacco taxes for improving the quality of health care for Michigan residents; and limited school millage requests to two per year.

The accompanying twenty-four implementing state statutes established a statewide property tax levy for education at 6 mills on all property. In Michigan, for property taxation purposes, property is assessed at 50 percent of market value. Additionally, a local proper-

ty tax of 18 mills on all non-homestead property (property other than the principal homestead and farmland) was established. Non-homesteads will pay a minimum of 24 mills and local district voters must approve the 18 mills levy in order for the district to qualify for the district's full state aid. Local voters would be required to approve the 18 mill non-homestead levy once the district's current authorized levy expired. A new real estate transfer tax of two percent on the gross sales of real estate transactions was established. However, since its adoption, the legislature has since amended the legislation and rolled back the real estate transfer tax to 0.75 percent. Cigarette taxes were increased from $0.25 to $0.75 per package and a new 16 percent tax on all tobacco products (cigars, smokeless and pipe tobacco). A new interstate phone tax at six percent was established with an exemption from the tax provided for 800 numbers and WATS lines.

The state income tax rate was decreased from 4.6 percent to 4.4 percent. The portion of rent estimated as property taxes was increased from 17 percent to 20 percent for the purpose of calculating the homestead property tax credit for renters. Finally, a new lottery game called Keno was proposed, but has not been implemented. The state's single business tax (SBT) rate was not changed by the proposal; however, subsequent to the adoption of the school reform package, the legislature rolled back the SBT rate from 2.35 to 2.25 percent.

New Funding Formula for Public Schools

The total yield of the new taxes—local and state property tax, revenues from the state's general fund and existing targeted funding plus federal funds for schools—totaled $10.5 billion which represented a small increase (less than three percent) for education as a whole. However, the distribution of funding for schools was dramatically altered.

Prior to the new funding plan, local property taxes provided 57 percent of school operating revenue (Figure 1). Under the new plan, property taxes, both state and local, will provide around 35 percent of funding.

Prior to the school reform initiative, per pupil expenditures in the state ranged from a low of $2,800 to a high of $10,400 with 42 percent of the districts below $4,500 (Figure 2). A basic provision of the new funding plan attempts to reduce the per pupil funding gap between school districts. In 1994-1995, schools currently spending less than $4,200 per pupil will receive $4,200 or their 1993-1994 expenditure level plus $250. Schools currently spending between $4,200 and $6,500 will receive their 1993-1994 expenditure level plus up to an additional $250 per pupil. Schools spending more than $6,500 will receive their 1993-1994 expenditure level plus $160, but the state will

only reimburse the district $6,500, the balance to be raised through voter-approved supplemental millage. Local districts were authorized, with voter approval, to seek an additional 3.0 mills (enhancement millage). The funding plan eventually will establish the basic foundation grant to schools at $5,500. Future growth in the foundation grant is double indexed based on growth in state revenues and increase in the number of K-12 students.

In addition, the state will require local districts to assume retirement and Social Security costs previously borne by the state. This provision will result in a number of school districts not experiencing a net gain in revenue because of offsetting new costs. These districts may be forced to either reduce expenditures or seek enhancement millage.

Figure 1. School Fund Sources

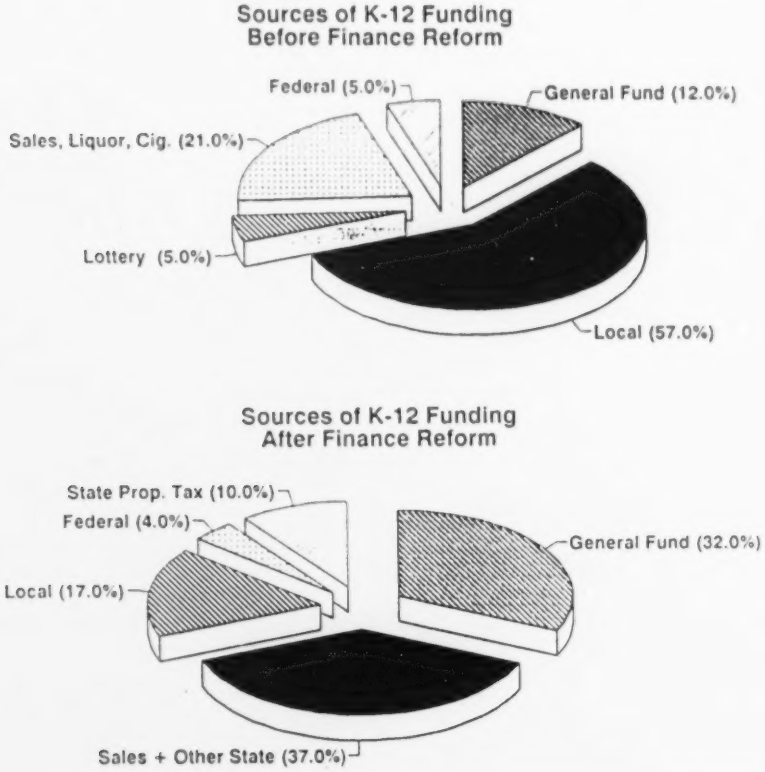
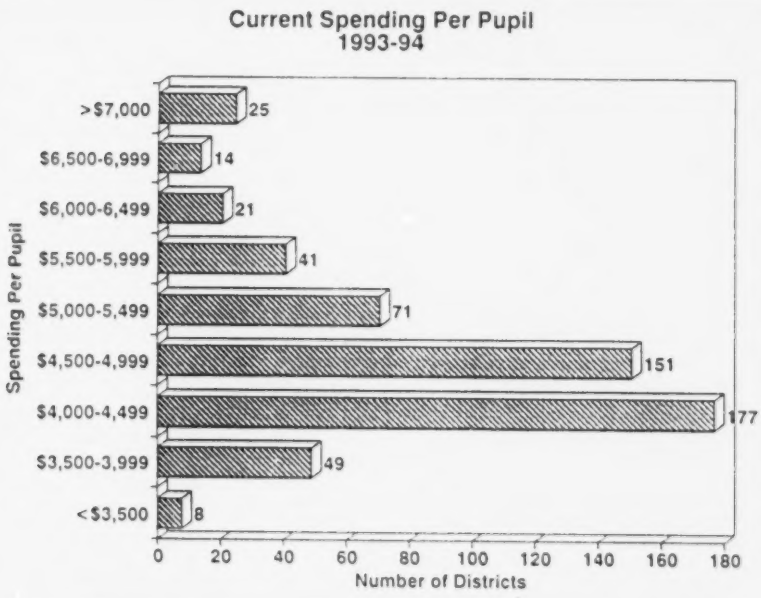


Figure 2. Current Spending Per Pupil Per School District



Source: Kleine

Impacts and Emerging Policy Issues

While the new school funding plan and property tax reform measure reduced property taxes for a majority of landowners, the plan was actually a tax shift. Total tax collections will only be reduced by net $300 million. The funding plan changes the incidence of taxation, that is, who bears the cost for funding of K-12 education. Winners under the plan were high-income households with high-valued homesteads. Losers under the plan generally were low- to middle-income families who are in a high consumption stage of life, mainly families with children who are in family household formation. These households will bear a substantially higher sales tax burden.

The funding plan had strong support from the state Chamber of Commerce and the business community. Businesses and firms collectively will bear a higher total tax burden. The interaction between the state tax system and federal tax system accounts for the anomaly. In fact, in several school districts, both homeowners and businesses will have a higher property tax burden than under the previous school funding arrangement.

While the new funding plan reduces the per pupil expenditures

gap, a spending gap of between $4,200 and $10,400 will remain, with the gap closure to be minimal in the long run.

Many voters assumed millage votes would no longer be needed. Quite to the contrary, voters will be required to approve the 18 mill non-homestead levy and supplemental millages put forth by local school districts. Thus far, in more than 70 percent of the school millage votes, districts have been requesting supplemental millage and voters appear reluctant in a majority of the cases to approve additional millage levies.

Local governments will experience a revenue decline as a result of lower property tax collection from which they had been assessing a one percent collection fee. The impact of the assessment cap, combined with the constitutionally-required rollback of millage rates when assessment increases exceed the consumer price index, will result in the ratcheting down of authorized millage rates in the long run. Local units, in order to recapture their authorized millage rate once it has been rolled back, will be required to seek voter approval. Michigan county governments will also experience a revenue decline as a result of lower earnings from delinquent tax collections, assuming the same rate of tax delinquencies.

Questions remain about the impact of the real estate transfer tax on the real estate market and the capping of property assessments. The capping provision does permit a full recapture of capped value once the property is sold. Based on experiences in other states that have initiated property tax reduction measures, it appears tax capitalization occurs, resulting in higher real estate values in the long run.

School Quality Issues

As previously mentioned, a provision in the school reform program enabled the establishment of "charter schools." Schools could be chartered by any public institution—local school board, community college, or university. Denominational schools are not eligible to become charter schools. The governor estimated that 200 new charter schools would be formed over the next two years. Since the legislation was adopted, six charters have been filed. Central Michigan University is sponsoring five of the charter schools and a home school organization is sponsoring the Noah Webster Academy (Gendreau). The American Civil Liberties Union is challenging the constitutionality of the Noah Webster Academy, alleging that public funds would be allocated to a school teaching religion. A state court has ruled that whether the school qualifies as a charter school should be determined by the State Department of Education. A charter school would receive a maximum of $5,500 per pupil or the revenue per pupil of the district in which the chartered school is located, whichever is less.

Additional provisions lengthened the number of hours of the school year, mandated a state curriculum, established school performance measures, revised the funding of adult education, provided targeted funding for schools with "at-risk students," and addressed safety and security in schools.

Impact on Agriculture

The total state equalized value (50 percent of market value) of agricultural land in Michigan in 1993 was $6.5 billion or 4 percent of total state equalized value. Data obtained from the U.S. Department of Agriculture's Economic Research Service (USDA-ERS) indicate that gross property taxes per acre on agricultural land prior to the plan was approximately $34. Under the new funding plan, gross property taxes per acre will drop to $20 per acre or a 57 percent decrease. It should be pointed out that Michigan enacted a general homestead property tax credit program in 1972 and a farmland preservation tax credit in 1974. Currently, 48 percent of all agricultural land is enrolled in the farmland preservation program. The combined credits paid to enrolled agricultural landowners totaled approximately $80 million which represented 50 percent of the enrolled landowners' property tax liability.

Therefore, the new school funding plan provided the largest benefit to agricultural landowners who were not enrolled in the farmland preservation program. An emerging policy issue for agriculture is "what happens to the agricultural landowners who are currently enrolled in the farmland preservation program, but who, because of changes in school financing, now do not reap the stream of tax credits as previously provided yet are under a development rights restriction?" No doubt the legislature will be asked to address the issue in its next legislative term. Landowners enrolled in the farmland preservation program do not bear economic costs because of the school reform measure since they were insulated against property tax increases in the first place, although as the level of benefits—property tax rebates—decline, the accumulated lien from the rebates is reduced.

Conclusion

The change in funding of Michigan's 557 public school districts was accomplished through non-marginal change. It is presently premature to judge the success or failure of the enacted reform measures. The elimination of property taxes for schools enacted by the legislature in July, 1993, set in motion a series of statutory and constitutional changes that will have far-reaching impacts not only for K-12 education, but for local governments as well. The reform changed not only the method of school finance, but the incidence of taxation in Michigan, thereby creating winners and losers. Michigan

is currently experiencing above-average economic growth, thus state revenue collections have exceeded expectation, creating a small surplus for the school funding program. Most public finance observers forecast a revenue shortfall for the 1996-1997 school year. It is unlikely that revenue collections will maintain their current pace and the guaranteed funding commitments for K-12 educations will result in reductions in other state budget areas.

The impact of the adopted school quality reform measures—lengthening the school year; increasing competition through the establishment of charter schools (public school academies); endorsing a state-mandated school curriculum; targeting monies for "at-risk" students; recommending improved security measures to improve school safety; and changing the funding of adult education—is yet to be determined.

While the new school funding distribution formula closes the funding gap from $7,600 per pupil (prior to proposal) to $6,200 for the 1994-1995 school year, the funding gap will not be substantially closed in the long run. Although the foundation guarantee will eventually increase to $5,500, indexed for future years, it is expected the high-spending districts' funding per pupil will also increase, thus it is possible a $5,000-per-pupil funding gap will continue to exist.

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